COM/LYN/msc/mel* **ALTERNATE DRAFT** Agenda ID # 3905
Alt. to Agenda # 3899
Ratesetting
Item XX 09/23/2004

Decision **ALTERNATE DECISION OF COMMISSIONER LYNCH**
(Mailed 9/9/2004)

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Application of Southern California Edison Company (E 338-E) for Authority to Institute a Rate Stabilization Plan with a Rate Increase and End of Rate Freeze Tariffs.	Application 00-11-038 (Filed November 16, 2000)
Emergency Application of Pacific Gas and Electric Company to Adopt a Rate Stabilization Plan. (U 39 E)	Application 00-11-056 (Filed November 22, 2000)
Petition of THE UTILITY REFORM NETWORK for Modification of Resolution E-3527.	Application 00-10-028 (Filed October 17, 2000)

OPINION IMPLEMENTING A PERMANENT ALLOCATION OF THE ANNUAL REVENUE REQUIREMENT DETERMINATION OF THE CALIFORNIA DEPARTMENT OF WATER RESOURCES

I. Summary

The primary purpose of this decision is to adopt a cost allocation methodology that will be applied to the revenue requirement of the California

Department of Water Resources (DWR) for its power purchases in 2004 and beyond.[1]

The methodology we adopt is effectively a compromise between the proposals presented by the parties. We do not adopt the proposed settlement agreement,[2] nor do we adopt any one party's litigation position. The allocation methodology we adopt leaves the variable costs of the DWR contracts as previously allocated in D.02-09-053, and separately allocates the fixed costs of the DWR contracts as follows: PG&E 43.75%, SCE 43.75%, and SDG&E 12.5%.[3] Consistent with D.04-01-028, this methodology is applied retroactively to January 1, 2004. (*Id.*, p. 3.)

II. Background

This Commission has previously established allocations for the DWR revenue requirement for 2001-2002 (see, D.02-02-052), and for 2003 (see, D.02-12-045). For 2004, on an interim basis, we have continued to use the 2003 allocation methodology. (D.04-01-028, as modified by D.04-02-028.) In this proceeding, we are adopting an allocation methodology applicable to 2004, but also applicable for the remaining term of the DWR power purchase contracts.

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[1] For more background on DWR's power purchase program and revenue requirement, and on the relevant statutes, see Decision (D.) 02-02-052, pp. 6-12.

[2] The settlement agreement was proposed by Pacific Gas & Electric Company (PG&E), Southern California Edison Company (SCE) and The Utility Reform Network (TURN). It was generally supported by the Commission's Office of Ratepayer Advocates (ORA), and strongly opposed by San Diego Gas & Electric Company (SDG&E).

[3] D.02-12-045 used the terms "fixed" and "variable" costs. In this proceeding, these terms were largely referred to respectively as "non-avoidable" and "avoidable" costs.

Based upon DWR's original 2004 revenue requirement determination, the parties litigated the methodology to be used for the permanent allocation. Opening and reply testimony was submitted by PG&E, SCE, SDG&E, ORA, and DWR, evidentiary hearings were held, and opening and reply briefs were filed by the three utilities.[4] Subsequent to the submission of briefs, DWR submitted a supplemental determination, modifying its revenue requirement for 2004.[5] Pursuant to an ALJ Ruling, the parties submitted comments addressing the supplemental determination. This decision allocates the 2004 revenue requirement of DWR as modified by the supplemental determination.[6]

This supplemental filing further refines the revenue requirement approved earlier this year, but it still includes costs that would have DWR collect hundreds of millions of dollars more than it needs to cover its 2004 expenses. The supplemental filing includes approximately $133 million in "extra" revenues, above and beyond those funds needed to maintain the 2004 minimum reserve requirement. DWR may believe that it may collect money over and above the amount it needs from ratepayers this year to cover its costs, to anticipate the extra 2004 revenues can reduce electric rate fluctuations in subsequent years, we note that under the rate agreement (see D.02-02-051) between DWR and the PUC,

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[4] ORA submitted only an opening brief, and DWR submitted a memo concurrently with the parties' reply briefs.

[5] The effective submission date of the supplemental determination was April 22, 2004. (See, DWR Letter Memorandum dated May 17, 2004.)

[6] One difference between the two is that they are based on different modeling runs. The original revenue requirement determination was based on Prosym Run 43, while the supplemental determination is based on Prosym Run 45. The allocation adopted today is based on Prosym Run 45, as reflected in Appendix A.

the PUC's clear role is to set rates sufficient to collect DWR's revenue requirement. DWR is not expected to engage in ratemaking or make assumptions about costs to affect ratemaking, and in fact, the rate agreement requires only that DWR submit to the PUC its revenue requirement reflecting actual costs.

Second, we are aware that DWR shall be receiving about $160 million from the El Paso settlement in 2004. We are concerned that these revenues have not been included in the supplemental filing. The receipt of $160 million in revenues that are not reflected in DWR's revenue requirement would further lead to DWR's over collections in 2004. IF DWR were concerned that the costs for 2005 might cause rate increases unless DWR "overcollect" by $133 million in 2004, DWR could instead use 83.1% of the El Paso monies ($133 million) it will receive pursuant to a completed final settlement to offset 2004-2005 costs and thereby maintain stable rates, while providing ratepayers with $160 million in relief.

In sum, in DWR's supplemental 2004 filing, DWR will receive over $290 million in revenues that are above and beyond what it forecasts it needs to cover its ongoing costs. It may be attractive for DWR to have unused money available to renegotiate contracts with suppliers to increase upfront payments to those suppliers, but we note that such future settlements are speculative at best. In addition, nowhere in AB1X does it authorize speculative future deals to which DWR has not yet committed. Moreover, given AB1x's suset of DWR's contracting authority, the statutory authority for any additional purchasing by DWR is unclear.

On April 22, 2004, the settling parties submitted a motion for leave to submit their proposed settlement agreement. Parties submitted comments and reply comments on the proposed settlement, along with related procedural motions. SDG&E consistently and vociferously opposed the proposed settlement, while ORA generally supported it. The assigned ALJ allowed for submission of the proposed settlement, granted SDG&E's request for evidentiary hearings, and ordered the settling parties to present witnesses for cross-examination. Evidentiary hearings on the proposed settlement were held on June 14 and 15, 2004, with parties submitting opening briefs on the proposed settlement on June 25, 2004, and reply briefs on July 2, 2004.Permanence of the Allocation

All parties agree that the allocation methodology that is adopted here should be permanent. (See, e.g., SCE Opening Brief, p. 43, PG&E Opening Brief, p. 4, SDG&E Opening Brief, pp. 2-3.) We concur. Annual litigation of the allocation methodology is not an efficient use of the parties' or the Commission's time and resources. After several cycles of experience and the completion of an extensive public comment process at this commission we find it appropriate to adopt a permanent allocation methodology, and eliminate the annual litigation process we have used to date.

III. Proposed Settlement Agreement

Given the broad-based support among the parties for the proposed settlement agreement, we must give it serious consideration. At the same time, we acknowledge SDG&E's questioning the legitimacy of a settlement entered into by two parties (who already largely agreed with each other) in which those two parties agree to shift costs to a third, non-settling party. (SDG&E Comments re Proposed Settlement, p. 27.)

The proposed settlement divides DWR's revenue requirement into three categories, referred to as: (1) as DWR's contract costs; (2) DWR's other power costs; and (3) planned changes in power charge accounts. (Motion of Settling Parties, p. 4.) Each category receives its own allocation approach.

The proposed settlement would start by allocating DWR's contract costs on the same basis that the contracts were allocated for operational purposes in D.02-09-053. This method is generally referred to as the "cost-follows-contracts" or "CFC" methodology, and was generally advocated in the litigation positions of PG&E and SCE.

This initial CFC-based allocation would then be adjusted by "Fixed Annual Adjustment Amounts." (Brief of Settling Parties, pp. 8, 14.) According to the Settling Parties, using these fixed annual adjustment amounts results in the projected "above market costs" of DWR's long-term contracts being allocated to the customers of PG&E, SCE and SDG&E based on utility allocation percentages of 43.6%, 42.6%, and 13.8%, respectively.[7] These percentages "[A]re designed primarily to constitute a reasonable reflection of the relative net-short positions of the three utilities that DWR initially sought to serve when it entered into its contracts, and the other equity "yardsticks" advanced by the parties to this proceeding." (*Id.*, p. 8.)

The same utility allocation percentages would be applied to DWR's other power costs, which includes all of DWR's administrative, general, and extraordinary item expenses, and any new cost categories specified by DWR not directly related to a specific contract. (*Id.*, p. 7.)

For the third category, planned changes in power charge accounts, which reflects the planned annual changes in the operating reserves maintained by

[7] These annual adjustments are reduced to zero for the years 2012 and 2013.

DWR, different percentages would be applied, of 44.4% for PG&E, 45% for SCE, and 10.6% for SDG&E.

The proposed settlement agreement is in fact an odd hybrid. It starts from a CFC approach, which in its pure form has the advantages of simplicity, ease of administration, and not requiring the use of confidential information. A pure CFC approach does, however, have one serious problem – it is simply not equitable, as even its advocates will admit. (SCE Opening Brief, p. 29.)

The benefits and flaws of a CFC approach are well summarized by SCE's witness:

> As Edison's testimony states, CFC allocation methodology provides certain operational and administrative benefits that none of the other allocation methodologies provide, but we were also very clear in our testimony that it is not cost-based, but neither are the other allocation proposals; it is not equitable, and neither are most of the other allocation proposals; but that in -- in large, when you look at all the factors considered, it's a reasonable way to allocate these costs for what is a very difficult decision the Commission has to make. (SCE witness Cushnie, Transcript p. 7237.)

The allocation of fixed costs resulting from a CFC approach is somewhat arbitrary, as we noted in D.02-12-045:

> Since DWR signed contracts for a statewide need, allocating the fixed costs of contracts to utility service territories based upon geographic location does not match how or why those contracts were obtained. It would be arbitrary and unfair for one or more service territories to end up with a disproportionate number of high-priced contracts when DWR was not trying to balance costs among service territories. (*Id.*, p. 11.)

In order to remedy this problem with the CFC approach, the proposed settlement adjusts the CFC allocation through the fixed annual adjustment amounts. The logic behind this approach is explained:

> The customers of the utilities must take power from DWR, and must bear the costs of that power. To the extent that the costs are equal to the market costs for the power, there is no burden associated with the requirement that customers take DWR's power. It is only to the extent that the costs of the power exceed its market value that a burden is imposed on customers. Therefore, in allocating the DWR Annual PCRR, the Settlement Agreement focuses on achieving a result that fairly allocates the above-market component of the DWR contract costs to the customers of the three utilities. Under the Settlement Agreement, a CFC allocation is adjusted, through the use of Fixed Annual Adjustment Amounts, so that each utility's customers are expected to bear a market price for the power they receive from DWR, plus a fair share of the above-market component of DWR's costs. (Brief of Settling Parties, p. 15.)

While the underlying logic - attempting to fairly allocate the above-market costs of the DWR contracts – is sound, the actual method the proposed settlement uses to calculate above-market costs is flawed.

As SDG&E points out, "The calculation of the above-market costs of a contract requires forecasts of a variety of assumptions, including gas and electric market prices and conditions." (SDG&E Comments, p. 15, citing Exhibit 04-21.) SDG&E goes on to list some of the other factors for which assumptions would need to be made, particularly those relating to the market value of the DWR contracts. (*Id.*, pp. 15-16.)

In D.02-09-053, this Commission raised similar criticisms of the above-market cost metric proposed by SCE as a basis for determining the ultimate reasonableness of the various contract allocation proposals in that proceeding:

> SCE's methodology relies on several calculations and projections that are based on subjective assumptions, including a forecast of future market prices (forward price curve) based on broker quotes and (after 2007) growth rate assumptions, and calculations of future hourly market prices that are derived from a regression analysis of the forward price curves and historical market prices. (D.02-09-053, p. 31.)

Hence, SCE had originally proposed (as one alternative) that there should be an annual determination of above-market costs. (See e.g., SCE Opening Brief, p. 16.) The proposed settlement, however, is based upon a one-time forecast of above-market costs, applicable for the duration of the DWR contracts. SDG&E vigorously attacks this aspect of the proposed settlement, arguing that use of a locked-in ten-year forecast of above-market costs is unreasonable. (SDG&E Brief re Proposed Settlement, pp. 24-32.) There is some validity to SDG&E's criticisms. As SCE originally stated in support of its litigation position: "An annual determination of the AMC costs on a forecast basis is necessary as a ten-year projection of such costs will be unreliable in the later years." (SCE Opening Brief, p. 7, fn. 6.)

In addition to the difficulty of calculating the above market costs, the methodology does not (and cannot easily) reflect the actual value of a particular contract or contracts. SDG&E argues that the methodology used by the settling parties does not explicitly value capacity or ancillary services, among other things (SDG&E Brief re Proposed Settlement, pp. 26-27), nor does it reflect the value of the contracts in the context of the utility's supply portfolio (SDG&E Comments, p. 16). The settling parties note that their methodology does not value the dispatchability of contracts (see, e.g., Reply Brief of Settling Parties, pp. 13-14), and while this may tend to favor SDG&E, it reflects yet another problem with attempting to calculate the above-market component of the contracts.

Overall, the forecast of above-market costs used in the proposed settlement is simply not good enough to provide a principled basis for allocating the costs of the DWR contracts.

A more serious problem with the proposed settlement is its fundamental reliance upon the relative net-short positions of the three utilities for the 2001-2002 time period. The "Utility Allocation Percentages" that form the basic yardstick for the proposed settlement "[A]re designed to constitute a reasonable reflection of the relative net-short positions of the IOUs that DWR initially sought to serve when it entered into its contracts." (Motion of Settling Parties, p. 6.)[8]

The propriety of allocating future revenue requirements on the basis of forecasts of the utilities' net-short positions for 2001-2002 was actively litigated.

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[8] The Motion of the Settling Parties states that it used "three principle net short allocation percentages presented in the proceeding:" SCE's proposed net short percentages based on D.02-02-052, PG&E's percentages based on DWR's Prosym Run 19g, and percentage shares derived from the Nichol Declaration. (*Id.*, p. 14.) The first source addresses the 2001-2002 net short, while the other two contain forecasts for both 2001-2002 and for future years. The Motion, however, is not clear what forecast or forecasts in Prosym 19g and the Nichols Declaration it used, or what weight was given them. Based on the language of the Motion itself we can only conclude that the utility allocation percentages are largely, if not totally, based upon the 2001-2002 net short.

(See, e.g., PG&E Opening Brief, pp. 14-19.) The basic idea behind the use of the net-short forecasts is that DWR was procuring power to fill the net-short positions of the utilities, creating a causal link between the net-short positions and the size and cost of the contracts themselves. The net-short forecasts are in essence treated as a proxy for the state of mind of DWR at the time it entered into the contracts that are at issue here.

The main problem with use of the individual net-short forecasts for allocating the costs of the contracts is the fact that DWR's purchases and contracts were made to cover the *aggregate* net short position of all three utilities, not the *individual* net short of each utility. (See, e.g., D.02-12-045, p. 12.) Contracts were signed to meet statewide needs, not the needs of individual utilities. (*Id.*, p. 11.) Second, a forecast of the net-short for only 2001 and 2002 does not actually reflect what DWR may have expected each utility's needs (and other sources of electricity, such as hydro) to be over the life of the contracts. (See, D.02-09-053, p. 30; SDG&E Reply Comments, pp. 5-6.) Also, as we noted in D.02-12-045, the amount of energy actually delivered to each utility's customers by the remaining DWR contracts does not necessarily match each utility's net short. (D.02-12-045, pp. 11-12.) While superficially appealing, the net short forecasts for 2001-2002 do not provide a principled basis for allocating the costs of the DWR contracts.

Accordingly, we do not approve the proposed settlement agreement.

IV. Litigation Positions, Past Allocations, and Fairness Metrics

Since we have rejected the proposed settlement agreement, we next consider the litigation proposals of the parties. Unfortunately, we also find the litigation proposals to be unsuitable for permanently allocating the costs of the DWR contracts.

The litigation proposals of PG&E and SCE, while not identical, share a number of flaws. Among other things, the PG&E and SCE proposals are based upon the inequitable CFC methodology, rely upon flawed estimates of above-market costs, and invite significant re-litigation. The proposals of ORA and SDG&E are based upon the allocation methodology adopted for 2003 in D.02-12-045. However, the ORA proposal is somewhat incomplete, and SDG&E incorporates additional self-serving resource assumptions in its proposal.

We will, however, take as our starting point the *pro rata* allocation methodology we adopted in D.02-12-045. This allocation methodology is generally advocated in the litigation positions of ORA and SDG&E, and partially supported by the litigation position of PG&E. In D.02-12-045, the adopted methodology pooled the costs of the DWR contracts, reflecting the fact that DWR's contracts were signed with the intent to meet the aggregate need of the utilities. (*Id.*, pp. 11-13.) Aggregating the costs of the contracts accordingly matches the way the costs were actually incurred, and also spreads the pain of those contracts that are particularly expensive. (*Id.*)

After pooling the DWR contract costs, D.02-12-045 then allocated the costs to the customers in proportion to the quantity of energy supplied by DWR to each utility for 2003, as forecast by a modeling run performed by DWR. The use of supplied energy as the basis for the allocation was appropriate, as it allocated the costs of the contracts proportionally to the benefits received from the contracts.

D.02-12-045 used the most current forecast for which there was an adequate record. (*Id.*, pp. 27-28.) Given that the forecast was for one year only, this approach had a reasonable probability of accuracy. However, in this proceeding we need to find a basis for allocating the costs of the DWR contracts through 2013, when the last of the contracts expire. Using a forecast of supplied energy over a relatively long time period, however, raises some of the same concerns we have expressed regarding the accuracy of the above-market cost forecast.

In addition, it is not clear what forecast should be used. One approach would use the most recent DWR forecasts of supplied energy for the relevant time period. (See, e.g., SDG&E Opening Brief, p. 9.) This approach, by using the most recent forecast reflecting the latest data and assumptions, would hopefully be the most accurate. Even so, its accuracy is uncertain at best. In addition, SCE argues that the use of current forecasts requires the use of confidential information, making it difficult for parties to review and confirm the results of the allocation methodology. (SCE Opening Brief, p. 32.)

On the other hand, it is also possible to use a forecast based on a model used by DWR back when it was entering into the contracts. (See, e.g., PG&E Opening Brief, p. 18.) This, like the settlement's use of the 2001-2002 net short figures, is an attempt to mirror the state of mind of DWR at the time it executed the contracts. It is, however, an improvement on the use of the 2001-2002 net short, as it reflects DWR's then-current projections over the longer term, and more closely corresponds to the length of the contracts that DWR was signing. As a proxy for DWR's state of mind, this approach may not be bad, but its ultimate accuracy is likely to be worse than the more recent forecasts.[9] Neither

[9] In addition, there was some controversy about the most appropriate source for the historical data and forecasts available to DWR. The best sources appear to be what

Footnote continued on next page

the current forecast nor the historical forecast is ideal, and while both have benefits and flaws, it is difficult to determine which would be the lesser of two evils. Ultimately, it is not clear that any forecast in the record of this proceeding is really any good, and we decline to base our allocation on the available forecasts.

We cannot predict the future, and in this case the past is also of little help, as the DWR contracts at issue were signed at a time of crisis, confusion, and uncertainty, rendering our traditional notions of cost causation difficult to apply. In large part we are "spreading the pain" of a unique occurrence, for which we do not have sufficient information from DWR to apply our standard metrics. Accordingly, we must find another way to reach a fair allocation. Fortunately, the parties have provided such a route.

As a guide to evaluating the various allocation methodologies, several parties recommended the use of a "fairness yardstick" or "fairness metric," against which allocation proposals could be measured.[10] Not surprisingly, there was some divergence among the parties among what should be considered fair. Nevertheless, given the problems of the other methods proposed in this proceeding, the fairness metrics appear to provide the best avenue for developing a fair and equitable cost allocation.

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were referred to as the "Nichols Declaration" and "Prosym Run 19g" but it is not clear what relative weight each of these sources should be given, if any.

[10] In essence, the "Utility Allocation Percentages" in the proposed settlement also represent a fairness metric. (Motion of Settling Parties, p. 4.)

In fact, it is quite informative to look at the fairness metrics as well as actual current and recent historical allocations.[11]

Source/Method	Allocation to:		
	PG&E	SCE	SDG&E
D.02-12-045[12]	44%	42%	14%
Interim 2004[13]	40%	47.3%	12.7%
PG&E Metric[14]	39%	48.4%	12.5%
SCE Metric[15]	48%	36%	16%
ORA Metric[16]	39.2%	48.3%	12.6%
Settlement Metric	43.6%	42.6%	13.8%

It is particularly interesting to note that two parties other than SDG&E (PG&E and ORA) were willing to argue that an allocation as low as approximately 12.5% would be appropriate for SDG&E. With the exception of SCE's Metric, the range of allocations recommended or previously adopted for SDG&E is also relatively narrow. Since all of the principles upon which we might base an allocation methodology appear to be flawed, we will simply use the concurrence of the parties to establish fixed allocation percentages that will be applied to the cost of DWR's contracts. Accordingly, we adopt an allocation of 12.5% for SDG&E.

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[11] For purposes of this table, Prosym Run 43 was used, as that run provided the basis for the parties' litigation proposals, including their fairness metrics.

[12] Allocation for 2003.

[13] As adopted in D.04-01-028 applying same method adopted in D.02-12-045.

[14] Based on method adopted in D.02-12-045.

[15] Based on forecasts of net short (SCE Opening Brief, p. 11).

[16] Based on method adopted in D.02-12-045.

There is less concurrence regarding the relative shares to be allocated to PG&E and SCE, but considering the levels of PG&E's Metric, SCE's Metric, and the Settlement Metric, it is appropriate to allocate the remaining 87.5% equally between the two. Accordingly, we adopt an allocation of 43.75% each for PG&E and SCE.

Use of fixed allocation percentages is consistent with the recommendation of SDG&E. According to SDG&E, fixed percentages eliminate the ability of utilities to shift costs to each other via their dispatch decisions (SDG&E Opening Brief, pp. 17-19), and also reduce the motivation to relitigate the allocation methodology (SDG&E Reply Brief, pp. 23-24).

V. Costs to be Allocated

Finally, it is not enough to simply determine allocation percentages. We must also clearly identify the specific costs to which those allocation percentages are applied. The categories of costs that have been discussed in this proceeding include total contract costs, unavoidable costs, avoidable costs, and above-market costs. Total contract costs include the avoidable costs, unavoidable costs, and above-market costs of the DWR contracts. For each individual contract, however, the relative proportions of each of these components can vary.

Avoidable costs were allocated on a CFC basis in D.02-09-053. In general, the parties have not recommended changing that allocation. In D.02-12-045, we allocated total costs and subtracted out the previously allocated avoidable costs to come up with a residual allowance of fixed costs. SDG&E recommends continuing to use that method. The settling parties prefer to base an allocation on above-market costs. While we do not adopt the above-market cost methodology, its proponents raise some valid criticisms of the calculation approach used in D.02-12-045.

SCE argues that the method used in D.02-12-045 (and advocated by SDG&E) treats avoidable contract costs as an economic burden, when in fact such costs should be considered an economic benefit: "Avoidable contract costs should only be incurred when they are projected to be less than the market value of the energy dispatched. As a result, avoidable contract costs will not be incurred when it is uneconomic to dispatch." (SCE Reply Brief, pp. 4-5)

SCE correctly points out that the residual calculation approach results in the customers of SDG&E, which has the largest percentage share of dispatchable contract energy, being allocated the smallest percentage share of the unavoidable contract costs. (*Id.*, p. 5.) While SCE does not support a "prorata" allocation, SCE argues that if a prorata allocation is used, the current residual calculation approach is unfairly biased. (*Id.*)

According to SCE,

> The Commission has already properly determined that avoidable contract costs should follow the physical contract allocation to ensure that least-cost incentives are maintained. As such, it is not necessary or useful to aggregate the DWR revenue requirement to implement a "prorata" allocation, and then residually determine the allocation of unavoidable contract costs by subtracting forecast avoidable contact costs. This proceeding has been established to allocate DWR's unavoidable contract costs. If a prorata methodology is to be implemented, it should be on the unavoidable contract costs only, and not incorporate avoidable contract costs which are actually an economic benefit to customers. (*Id.*, pp. 5-6.)

While we do not necessarily agree with every aspect of SCE's argument, the criticism of the residual calculation approach is generally well founded. In addition to the problems noted by SCE, in the course of this proceeding we have found that the parties are indirectly re-litigating the allocation of the avoidable costs of DWR's contracts, as the total cost approach we adopted in D.02-12-045 creates a direct link between the allocation levels of the unavoidable and avoidable costs.

Accordingly, we adopt SCE's alternate recommendation that the allocation factor be applied only to the unavoidable cost component of the DWR contracts.[17] Ironically, SDG&E made this same proposal during litigation of the 2003 revenue requirement allocation, but the Commission rejected it at that time. (D.02-12-045, pp. 12-14.) The methodology the Commission adopted for 2003 (and that SDG&E continues to advocate) actually resulted in a more favorable allocation for SDG&E than SDG&E's own. (*Id.*, Table A, p. 18.)[18]

The final results of the allocation methodology we adopt today are reflected in Appendix A.

VI. Surplus Sales

All three utilities propose that the sharing of revenue from surplus sales on a pro-rata basis between DWR and the utilities, as established by D.02-09-053, be eliminated. (See, e.g., SDG&E's Opening Brief, pp. 33-37.) DWR does not oppose the elimination of sharing revenues from surplus sales, but notes that as a result of eliminating the sharing of revenues of surplus sales, all DWR sales would be deemed delivered to retail end use customers. DWR states its willingness to

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[17] ORA proposes that gas tolling costs associated with must-take contracts be considered avoidable costs. We rejected this same proposal in D.02-12-045 (p. 17), and we reject it again here.

[18] The rate increase that SDG&E will see as a result of the allocation we adopt today is largely a reflection of the favorable allocation that SDG&E received for 2003.

work with the utilities and the Commission to amend the Operating and Servicing Agreements to accommodate a Power Charge calculation that reflects that all DWR power is delivered to retail end use customers.

In spite of the agreement between DWR and the utilities on this matter, the Commission should develop a more robust evidentiary record and allow for expanded public comment on the proposal than this 120 day proceeding has allowed. The current surplus sales methodology will remain in place for 2004, but we encourage the utilities and DWR to work together to bring the proposed changes before the Commission in the appropriate forum, so that we can implement any agreed-upon changes concurrently with our allocation of DWR's 2005 revenue requirement.

VII. Utility Specific Balancing Accounts

The utilities recommend the establishment of utility specific balancing accounts that would track the revenues received by DWR from the customers of each utility against DWR's costs (or revenue requirement) for those same customers. (See, e.g., SDG&E Opening Brief, pp. 37-38, SCE Opening Brief, pp. 46-47.) DWR has indicated that it is willing to create and maintain these accounts. We direct the three utilities to work with DWR to work out the details of implementing utility specific balancing accounts, consistent across all three utilities, and in compliance with all applicable statutes. The three utilities and DWR should coordinate with Energy Division staff in developing the details of the utility specific balancing accounts. The utilities shall submit advice letters within 75 days of this decision, describing the utility specific balancing accounts and how they work.

VIII. Future Proceedings

We intend to close this proceeding shortly. For future DWR submissions, such as its annual revenue requirement, we are considering opening one proceeding each year to address any and all DWR submissions, and related issues. In comments on this proposed decision, parties should provide any suggestions or recommendations they have for how such a proceeding would best work.

IX. Rehearing and Judicial Review

This decision construes, applies, implements, and interprets the provisions of Assembly Bill (AB)1X (Chapter 4 of the Statutes of 2001-02 First Extraordinary Session). Therefore, Pub. Util. Code § 1731(c) (applications for rehearing are due within 10 days after the date of issuance of the order or decision) and Pub. Util. Code § 1768 (procedures applicable to judicial review) are applicable.

X. Assignment of Proceedings

Loretta M. Lynch and Geoffrey F. Brown are the assigned Commissioners and Peter V. Allen is the assigned Administrative Law Judge in these proceedings.

XI. Comments on Alternate Draft Decision

The draft alternate decision of Commissioner Lynch was mailed to the parties in accordance with Pub. Util. Code § 311(d) and Rule 77.1 of the Commission's Rules of Practice and Procedure. Timely Comments were received from the settling parties (PG&E, Edison, and TURN), SDG&E, and ORA. In addition, the Department of Water Resources submitted a memorandum on August 9th. Reply comments were received from SDG&E and the settling parties.

ORA reiterates its general support for the proposed settlement agreement, but also suggests that if the Commission does not adopt the proposed settlement agreement, that the proposed settlement agreement be applied to the portions of the revenue requirement allocated to PG&E and SCE. (ORA Comments, p. 2.) ORA notes the objections to the use of a forecast of above-market costs, but recommends:

> However, among the parties that have agreed to use of the forecast, warts and all, that agreement should be allowed to stand. ORA therefore recommends that the portion of the revenue requirement assigned to PG&E and SCE be allocated consistent with the principles and methods of the Settlement Agreement, including use of an above market cost forecast. (Id.)

We do not have an objection to such an outcome, and in fact ORA's suggestion makes some sense.[19] Given the nature of the proposed settlement agreement, however, it is not clear how that suggestion would be implemented. In particular, the fixed annual adjustment amounts, which under the settlement

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[19] The settling parties also note that the Proposed Decision does in fact alter the balance struck by the proposed settlement between PG&E and SCE, and request that this balance be restored. (Settling Parties Comments, p. 14.)

agreement would flow between the three utilities, would now have to flow between only the two utilities. If in fact PG&E and SCE can work out a settlement that applies just to them, and not to SDG&E, we would consider a petition to modify this decision to adopt such a settlement. We would, however, prefer a settlement that includes all three utilities, and would even more gladly consider a petition to modify this decision to adopt a tripartite settlement.

SDG&E supports the proposed decision's rejection of the proposed settlement agreement (SDG&E Comments, pp. 1, 9-10), and also supports the proposed decision's permanent allocation methodology (id., pp. 1, 8-9). Nevertheless, SDG&E does not like the numbers that the proposed decision uses for allocating the unavoidable costs of the DWR contracts, at least the 12.5% number that applies to SDG&E. SDG&E argues that it should be allocated 10% of the unavoidable costs, rather than 12.5%. (Id. pp. 3, 9, 14.) SDG&E also argues that for 2004, the new allocation methodology should not be applied, but rather the existing interim methodology (adopted in D.04-01-028) should become the final allocation for 2004, with the new methodology to apply beginning in 2005. (Id. pp. 11-13.)

SDG&E basically raises two criticisms of the proposed decision. First, that it simply shifts too many costs to customers of SDG&E, resulting in SDG&E's customers bearing a significantly higher burden than they would under the current interim allocation, and second, that the proposed decision takes fairness metrics that were intended to be used to measure total costs and instead applies those metrics to unavoidable costs, resulting in a higher allocation to SDG&E customers. (SDG&E Comments, pp. 2-9.)

SDG&E is correct that the proposed decision results in SDG&E's customers being allocated significantly more costs than they were allocated in 2003 and under the interim 2004 allocation. SDG&E argues that the proposed decision erred in not acknowledging the cost shift or considering its impact on the customers of SDG&E. The proposed decision did in fact note that there would be a rate increase for SDG&E customers. (Proposed decision, p. 16, fn. 18.) The size of the difference in cost allocation between the existing methodology and the fairness metrics used by the proposed decision was expressly made part of the record in the comparison exhibit requested by the assigned ALJ (Ex. 04-COMP), and was in fact considered. SDG&E neglects to note that SDG&E received a highly favorable allocation for 2003 (even more favorable than that proposed by SDG&E), and that the proposed decision stated that the rate increase that SDGE will see as a result of the new allocation methodology is largely a reflection of that prior favorable allocation. (Proposed decision, supra.) In short, the movement from the low cost allocation SDG&E's customers got in 2003 (and in 2004 under the interim allocation) to a more equitable allocation results in a rate increase for those customers. The mere fact of a rate increase for SDG&E's customers, even a substantial one like the one here, does not by itself mean that the allocation is unfair, any more than a decrease in yearly income after the year in which one receives lottery winnings is unfair. The proper question to ask here, in response to SDG&E's criticisms, is whether the allocation adopted by the proposed decision is in fact fair.

SDG&E's other main criticism is that the proposed decision should not have applied the fairness metric to only unavoidable costs, but rather to total costs. (SDG&E Comments, pp. 3, 6-9.) According to SDG&E, the proponents of the 12.5% allocation to SDG&E, namely PG&E and ORA, originally intended the 12.5% allocation to be a percentage of the total costs, not just the unavoidable costs. By applying the 12.5% allocation to just the avoidable costs, the proposed decision results in a higher allocation to SDG&E than was actually proposed by PG&E and ORA. SDG&E calculates that an allocation of 12.5% of total costs would be equivalent to an allocation of 10% of unavoidable costs. Accordingly, SDG&E argues that its customers should be allocated 10%, rather than 12.5%, of the unavoidable costs. (Id., pp. 3, 9.)

SDG&E is generally correct that PG&E and ORA originally proposed that their fairness metrics apply to total costs rather than unavoidable costs, and SDG&E is also correct that by applying the 12.5% allocation to unavoidable costs, rather than to total costs, the proposed decision resulted in a higher relative allocation to SDG&E.

Again, the ultimate question, however, is whether the allocation of 12.5% of unavoidable costs is fair, or if it should be changed to 10% of unavoidable costs, as argued by SDG&E. The proposed decision, in deciding to allocate only the unavoidable costs, determined that the total cost allocation used in D.02-12-045 was unfairly biased. By arguing that the unavoidable cost allocation here should be 10%, SDG&E is essentially trying to reproduce the result, if not the methodology, of that prior approach. In essence, SDG&E ignores the proposed decision's critique of the prior allocation methodology. SDG&E also ignores the fact that both PG&E and ORA have subsequently moved away from their original position, and now support an allocation for SDG&E's customers of 13.8% of the above-market costs. While SDG&E attacks the details of the settling parties' above-market cost calculations, SDG&E fails to address the more general point, which is that under the prior allocation, SDG&E is burdened with a relatively low share of above-market costs.

Despite the fact that the proposed decision rejects the proposed settlement agreement, SDG&E continues to argue that the litigation process used by the

Commission in considering the proposed settlement agreement was unfair. SDG&E's argument is without basis.

In its comments, SDG&E states:

> It must also be noted that SDG&E has never been granted the opportunity to submit direct testimony and evidence challenging the merits of the Settling Parties' proposal or demonstrating how this unprecedented cost shift would unfairly burden SDG&E customers despite the countless attempts made by SDG&E to be granted this right that the rules and due process require. (Id. p. 10.)

SDG&E is correct that it has made countless attempt to submit direct testimony on the rate increase that would be seen by SDG&E customers under the proposed settlement agreement. (See, e.g. Motion for Reconsideration June 4, 2004.) Most recently, SDG&E has filed a "Motion of San Diego Gas & Electric Company for Commission Decision Allowing SDG&E to Present Direct Testimony and Evidence on the Contested Issues Raised by the Proposed Settlement in Accordance with Rule 51.6." SDG&E's Motion is denied for the reasons described below, among others.

First, SDG&E's Motion is moot, as this decision does not adopt the proposed settlement agreement. Accordingly, there would be no purpose in having SDG&E submit additional testimony regarding a rejected settlement proposal. Second, SDG&E's Motion is misleading, as the rate impacts about which SDG&E wants to submit testimony are in fact in the record in some detail. (See, May 24, 2004 Opening Comments of SDG&E, pp. 1-2, 5-9.) SDG&E was not precluded from presenting rate impact information, and in fact such information was before this Commission in this proceeding. Third, the rate impacts of the proposed settlement agreement on SDG&E's customers are not a contested issue, as the settling parties acknowledge that SDG&E's customers will see a rate increase. (See, e.g. July 2, 2004 Reply Brief of Settling Parties, p. 21.)

SDG&E requests that the new allocation methodology adopted here not be applied to 2004, but only in 2005, with the existing interim methodology becoming the final allocation for 2004. SDG&E argues that the implementation of the new allocation was delayed by the submission and consideration of the proposed settlement agreement. While this caused some delay, some delay was caused by DWR's submission of its supplemental revenue requirement determination, and SDG&E itself actively sought more delay. Regardless of the cause of the delay, SDG&E stipulated that the permanent allocation methodology adopted for 2004 would be applied retroactively to January 1, 2004. SDG&E's proposal is also a substantive argument in procedural clothing, as delaying the effective date of the new allocation would also result in a significant economic benefit to SDG&E's customers. Consistent with the stipulation of the parties, the new allocation is effective January 1, 2004.

The comments of the settling parties primarily constitute an extended argument extolling the virtues of the proposed settlement agreement, and detailing its superiority to the proposed decision. As our Rule 77.3 states, "Comments shall focus on factual, legal or technical errors in the proposed decision and in citing such errors shall make specific references to the record. Comments which merely reargue positions taken in briefs will be accorded no weight and are not to be filed." While we accordingly could largely disregard the comments of the settling parties, we will address a couple of the points raised by their comments.

First, the settling parties appear to misunderstand SDG&E's criticism of SCE's above-market cost analysis, and claim that SDG&E performed an above-market cost analysis that confirms the reasonableness of SCE's analysis. (Comments of Settling Parties, pp. 4-7.) As SDG&E points out, however, SDG&E's above-market analysis consisted of replicating the results of SCE's calculation, and then performing sensitivities on these results, "[T]o demonstrate the wide variability that occurs when the assumptions are changed." (SDG&E Reply Comments, pp. 3-4.) In essence, SDG&E did not perform an above-market analysis, but rather used SCE's above-market analysis as the starting point for its criticism of that analysis. (Id.) The fact that SDG&E's illustrative replication of SCE's analysis does in fact replicate SCE's analysis does not confirm the reasonableness of that analysis. The settling parties' claim that their above-market cost analysis should be adopted because it has been "litigation-tested" (Opening Comments of Settling Parties, pp. 3-4) is without basis.

The settling parties point out that the allocation of above-market costs that will result from the methodology adopted by the proposed decision is "just as uncertain, no more and no less so," as the allocation that would result from the proposed settlement agreement. (Comments of Settling Parties, p. 9.) While this may prove to be true, the fact that the proposed decision uses a method that in this particular element is the equal of the proposed settlement agreement does not constitute a factual, legal or technical error. SDG&E points out that the proposed decision does provide greater certainty than the proposed settlement agreement in its allocation of unavoidable costs. (SDG&E Reply Comments, p. 3.)

The settling parties note that the proposed decision concluded that the utility allocation percentages in the proposed settlement agreement were largely based upon the relative net-short positions of the three utilities for the 2001-2002 time period. (Comments of Settling Parties, pp.13-14.) The settling parties argue that the utility allocation percentages were in fact primarily based upon the Nichols Declaration and Prosym Run 19g, and only relied to a lesser extent on the 2001-2002 net short. (Id.) The settling parties are correct, and the language in the proposed decision on this issue has been modified accordingly.

DWR submitted a letter memorandum functioning as comments. DWR's comments are in the nature of commentary, rather than identifying specific errors, and generally do not require modification of the proposed decision. We will, however, incorporate DWR's suggestion to reword one ordering paragraph to more accurately reflect the relationship between the utilities, the Commission, and DWR.

The majority of DWR's memorandum expresses discomfort with the decision's findings that DWR has included more money in its supplemental revenue requirement than it needs to cover costs. DWR points out that "[a]ny reserves not spent by the department ultimately will flow back to ratepayers as part of the implementation of future revenue requirements." This is exactly our concern: that customers will be forced to pay hundreds of millions in excess funds to DWR in 2005. DWR claims in its comments that there is "no evidence in the record to determine DWR's 2004 actual costs." But this comment misses the point: DWR's April 19th Supplemental Determination requests $133 million more than DWR needs to meet its 2004 estimated expenses, as estimated by DWR in its own April 19th Supplemental Determination.

At a time when California's high rates are a contentious issue, we find that it is irresponsible to not do everything possible to keep current rates as low as possible.

Findings of Fact

1. Annual re-litigation of an allocation methodology to be applied to DWR's revenue requirement is neither efficient nor necessary.

2. DWR's supplemental revenue requirement determination was based on Prosym Run 45.

3. DWR's orginal revenue requirement was based on Prosym Run 43.

4. DWR's supplemental revenue requirement contains at least $290 million in revenues above and beyond the amount needed to cover DWR's estimated 2004 costs.

5. The Proposed Settlement's use of the costs-follows-contracts methodology is not equitable.

6. The Proposed Settlement relies upon a flawed forecast of future above-market costs.

7. The Proposed Settlement's use of historical forecasts of the net short positions of the three utilities as a basis for future cost allocation is too uncertain to be found equitable.

8. No party's litigation position proposed an equitable allocation methodology.

9. The pro rata allocation methodology adopted in D.02-12-045 was generally equitable, but the residual calculation approach used in that decision was flawed.

10. Several parties proposed fairness metrics for evaluating allocation methodologies. Avoidable DWR contract costs were previously allocated in D.02-09-053.

11. Avoidable DWR contract costs were previously allocated in D.02-09-053.

12. The utilities proposed, and DWR agreed to, the implementation of utility specific balancing accounts.

Conclusions of Law

1. A permanent allocation methodology for DWR's revenue requirement should be adopted.

2. The Proposed Settlement is inconsistent with D.02-12-045.

3. The Proposed Settlement is not equitable, and should not be approved.

4. The parties' fairness metrics provide an equitable basis for determining a permanent allocation.

5. The pro rata allocation methodology adopted in D.02-12-045 provides a reasonable starting point for a permanent allocation.

6. The residual calculation approach used in D.02-12-045 should be replaced with a separate calculation of fixed costs.

7. DWR should establish utility specific balancing accounts.

8. This decision construes, applies, implements, and interprets the provisions of Assembly Bill (AB)1X (Chapter 4 of the Statutes of 2001-02 First Extraordinary Session).

9. DWR should amend its 2004 supplemental revenue requirement to include the additional revenues from the El Paso settlement, and delete the $133 million in "extra" monies not needed to cover its estimated 2004 costs.

O R D E R

IT IS ORDERED that:

1. The allocation methodology adopted today for Department of Water Resources' (DWR) revenue requirement is permanent.

2. The Proposed Settlement is not adopted.

3. The allocation of variable costs previously adopted in Decision (D.) 02-09-053 remains unchanged.

4. The allocation of fixed costs of DWR's revenue requirement is: Pacific Gas and Electric Company - 43.75%, Southern California Edison Company - 43.75%, and San Diego Gas & Electric Company - 12.5%.

5. Pursuant to D.04-01-028, the allocation methodology is applied retroactively to January 1, 2004.

6. DWR and the utilities are directed to work together to implement utility specific balancing accounts, as described above.

7. The details of the allocation methodology we adopt are set forth in Appendix A.

8. Pub. Util. Code § 1731(c) (applications for rehearing are due within 10 days after the date of issuance of the order or decision) and Pub. Util. Code § 1768 (procedures applicable to judicial review) are applicable to this decision.This order is effective immediately.

This order is effective today.

Dated ____________________________, at San Francisco, California.

APPENDIX A
IOU Cost Allocation Summary

Total DWR Power Costs	$4,859,626,196
Administrative & General Expenses	$59,000,000
Extraordinary Costs	$37,054,868
Net Operating Revenues	($320,372,326)
Interest Earnings on Fund Balance	($32,212,129)
Other Revenues (Contract Settlements, Extraordinary Receipts)	($51,896,968)
Net Total of Variable Contract Costs, other Fixed Costs, and Net Revenues	**$4,551,199,641**

Cost Allocation	**PG&E**	**SCE**	**SDG&E**	**Total**
Direct-assign Variable Contract Costs	$91,240,650	$175,304,580	$204,519,570	$471,064,800
Calculate and Allocate Fixed Costs				
Total Fixed Costs = Total Costs less Variable Costs				$4,080,134,841
Adopted Allocator of Fixed Costs	**43.75%**	**43.75%**	**12.50%**	**100%**
Allocated Fixed Costs	$1,785,058,993	$1,785,058,993	$510,016,855	$4,080,134,841
Less: Off-system Sales	($18,078,332)	($215,013,323)	($39,486,934)	($272,578,590)
DWR Reconciliation to State Controller (Table A-1, line 19)	($2,910,791)	($2,910,791)	($831,655)	($6,653,237)
Subtotal: Fixed and Variable Costs	**$1,855,310,520**	**$1,742,439,458**	**$674,217,836**	**$4,271,967,815**
2001/2002 True-up Amounts (D.04-01-028)	($100,590,687)	$41,308,258	$59,282,429	$0
Sub-Total--IOU DWR Revenue Requirement before DA CRS	**$1,754,719,833**	**$1,783,747,716**	**$733,500,265**	**$4,271,967,815**
Less: Direct Access Power Charge-Related Revenues	($104,312,750)	($104,663,900)	($32,119,330)	($241,095,980)
Total Revenue Requirement	**$1,650,407,083**	**$1,679,083,816**	**$701,380,935**	**$4,030,871,835**
Shares of Revenue Requirement	**40.9%**	**41.7%**	**17.4%**	**100.0%**

Calculation of IOU Power Charge	**PG&E**	**SCE**	**SDG&E**	**Total**
2004 DWR Delivered Energy (kWh)	21,145,876	21,910,180	7,998,786	51,054,842
Variable Contract Component	$0.00431	$0.00800	$0.02557	$0.00923
Fixed Cost Component	$0.08442	$0.08147	$0.06376	$0.07992
2001/2002 True-up	($0.00476)	$0.00189	$0.00741	$0.00000
Less: Off-system Sales	($0.00085)	($0.00981)	($0.00494)	($0.00534)
Adjustment to Operating Account (Table A-1, line 19)	($0.00014)	($0.00013)	($0.00010)	($0.00013)
Adjustment to match DWR year-end balance	($0.00091)	($0.00091)	($0.00091)	($0.00091)
DA CRS Contribution	($0.00493)	($0.00478)	($0.00402)	($0.00472)
Total IOU Power Charge	**$0.07714**	**$0.07573**	**$0.08678**	**$0.07804**

(END OF APPENDIX A)

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